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In Place of Fear

Only a permanent, tax-based incomes policy based on cooperation can contain inflation while allowing growth and high employment

In the first half of the 1970s, Canada, along with the other developed capitalist countries, implemented restrictive aggregate demand policies in an effort to bring down inflation. The general feeling at the time was that while such policies would lead to rising unemployment, a noticeable reduction in inflation would be accomplished fairly quickly and the unemployment cost would be tolerable.

For almost a decade following the imposition of these policies, authorities in Canada and elsewhere looked with dismay at the inability of policy to reduce inflation by the desired amount. In the meantime the cost in terms of unemployment and lost output far exceeded expectations. To some it even appeared that policies of this sort would not work.

Events of the early 1980s pointed in a different direction. By allowing unemployment to rise rapidly to double digit rates, the authorities finally succeeded in bringing down inflation rates substantially. And this was accomplished here and elsewhere without the government being driven from office. If Mrs. Thatcher has proven anything at all it is that the limits to which unemployment rates can be driven in order to curb inflation without bringing down a government are much higher than ever suspected.

This finding has been a source of mutual congratulation among policy makers but we are of the opinion that such back-patting is very much unwarranted. The whole justification of past restrictive policies has been that they are necessary to wring inflation out of the system so that we can then return to full employment; but if any return to full employment following a "successful" anti-inflationary policy merely re-ignites the inflationary process, all our past pains and costs will have been in vain.

The fight against inflation will not have led in the long-run to full employment and price stability. Almost surely the authorities in seeing inflation start up will again revert to restrictive policies. The result in this case will be that inflation will again be conquered but only by returning to double digit unemployment and a stagnating economy.

It is our contention that government can always reduce and even eliminate inflation if allowed to push up unemployment rates without limit and keep them there. Thus "any fool can deflate the economy" as a former member of Mrs. Thatcher's cabinet recently remarked (anonymously). But we would argue that no Canadian government can ever hope to return the economy to full employment without inflation accelerating once again unless a correctly formulated permanent incomes policy is implemented at the same time. The basic difficulty is the existence under modern conditions of a bias towards inflation.

In all the developed capitalist economies, including Canada, over the past century institutions and attitudes have evolved that give rise to this inflationary bias. Inflation tends to accelerate whenever the economy is in the vicinity of what used to be called full employment. For present purposes this can be defined as the rate of unemployment at which the total number of job openings or vacancies equals the total number of unemployed.

The tendency for inflation to accelerate is new to Canada, having evolved mostly in the postwar period. It can be traced to developments in labour and product markets but mostly in the former. Our attention will therefore be concentrated on labour markets.

The postwar period of the 1950s and 1960s in Canada was one of sustained high rates of employment. There were periodic recessions that led to rising unemployment but, considering the period as a whole, the unemployment record was quite exemplary compared to earlier periods in Canadian history.

Not only was this a period of low unemployment it was one of rapid growth, by historical standards, leading to a rapid increase in incomes and living standards. At the same time Canada, like many other capitalist economies, put into operation a moderately generous welfare state. This provided many benefits for rich and poor alike, but of particular relevance was the introduction of the nation-wide unemployment insurance scheme.

The period of approximately two decades of near full employment created the affluence that enabled workers and their unions to accumulate emergency funds in the form of private savings and unemployment and strike funds.

All these developments increased labour's power relative to that of employers. Labour was in a better position to take a strike. In addition the expectation that full employment was the norm, or that recessions would be short, reduced management's incentive to resist labour's greater demands, as increased wages could be readily passed along in the form of higher prices.

More particularly, the postwar period saw the rising importance of "fairness" considerations in wage bargaining. Labour has increasingly come to demand that its real wages be protected from falling. Also, instant and nationwide mass communications have made workers aware of wage settlements elsewhere, giving rise to feelings of relative deprivation if their own wage settlements do not at least match those of other groups.

As a result, cost of living and relative wage considerations became the dominant forces in wage demands, unlike earlier periods when the more conventional economic forces of demand and supply played an important role. They also became a more important factor in actual wage settlements as full employment and affluence made these demands realizable.

Nowadays the economy is dominated by "fixprice" markets in which price changes, including wages, are little influenced by changes in demand and supply. Instead prices and wages respond to "cost" changes: unit production costs in the case of product markets and the cost of living and the wage structure in the case of labour markets. These fixprice markets are the basic elements of the two cost-push mechanisms, wage-price and wage-wage inflation, that make today's inflation so different from earlier periods.

Wage-price inflation, of course, is the process in which rising wages are passed through to prices followed by a feedback effect from higher prices to wages again, etc. Wage-wage inflation is one of wages in one market catching up with or leap-frogging wages elsewhere, significantly changing relative wages and giving rise to a perceived unfairness. This leads to wage demands elsewhere in order to re-establish the original "fair" wage structure. The process is intensified the more fragmented and the less synchronized are collective bargaining arrangements within a country.

The two cost-push mechanisms reinforce one another and give inflation an impetus which is independent of the state of the economy over a range of unemployment rates.

In contrast, in earlier times, when demand and supply forces dominated price and wage movements, inflation could be correctly described as demand-pull. Inflation rates would very much depend upon the amount of "slack" in the economy.

However, even though wage settlements have come to be dominated by fairness considerations, changes in aggregate demand do also affect wage settlements. As unemployment rates fall labour bargains more forcefully. Employers give in more readily to higher wage demands as labour can better take a strike and profit conditions improve.

This upward pressure on wage inflation would be present even if collective bargaining were highly centralized. When the labour movement is fragmented and decentralized, as it is in Canada, at lower unemployment rates labour's added aggressiveness increases the frequency of disturbances of the relative wage structure. Thus wage-wage as well as wage-price inflation is intensified during the course of a boom.

When the authorities apply restrictive demand policies because of a concern with inflation, unemployment rates rise and profits fall. If these policies are pushed far enough and maintained long enough, labour's aggressiveness will disappear while employers will take increasingly forceful attitudes towards wage demands. Demands for higher or merely stable real wages and compensation for improved relative wages elsewhere will fall on deaf ears. Employers will adopt a take it or leave it stance with workers and will eventually have their way.

However, if and when the inflation battle is thought won and restrictive policies are reversed, a point will again be reached in which fairness considerations begin once more to dominate wage demands and settlements. At that point the cost-push mechanisms are reactivated and the inflationary bias will again be evident. We will return shortly to the obvious implications of this bias for today's policies.

By almost universal agreement two of the most important economic goals of any society are to achieve full employment and to control inflation. The question is what kinds of policies will lead to these goals if modern capitalist economies like Canada are faced with an inflationary bias. We would argue that there are only two general types of policies to be considered.

First, there are the restrictive policies being followed in Canada today which, odd as it may seem, are intended in the long-run to be combined with an incomes policy based on fear.

Second there are policies that advocate a stimulative aggregate demand policy sufficient to return to and maintain full employment at the same time that an incomes policy based upon cooperation is put into effect.

Consider current policies first. The rationale behind today's restrictive policies is not merely to bring down inflation. This they will do as current developments in Canada and elsewhere confirm. Advocates of current policies have also argued (or at least implicitly assumed) that once inflation is under control, a careful reflation of the economy will allow a return to full employment without inflation.

Their argument is supposedly given added force if the authorities will behave in such a way that everyone believes they will maintain their restrictive policies until inflation is under control and will not hesitate to reintroduce them should inflation start up again.

Under these conditions, it is said, aggregate demand policy will be "credible" and therefore successful, as labour and management will voluntarily adhere to some wage and price guideline even when the economy returns to full employment.

Clearly, proponents of the restrictive policies of the last decade have an answer to our gloomy predictions about their policies; it is that labour (and employers) will have learned their lesson. They will now realize that if wage and price setting is not carried out in a way consistent with the national interest, the authorities will again apply restrictive measures. Recognizing this, the optimists argue, wages and prices will be set in a manner consistent with zero or low rates of inflation, and the inflationary bias will disappear (if it ever existed).

Allegedly, then, what is new and different today is that the induced fear of possible future restrictive policies will lead to a coordination of collective bargaining and price setting with the national goals of wage and price stability, all on a voluntary basis, if and when Canada returns to full employment. In other words, a successful voluntary incomes policy will be in effect, in which compliance with wage and price norms will be realized through fear, as employers and labour internalize the costs of their price and wage behaviour.

Is it likely that everyone will behave? Believers in the long-run value of restrictive policies would have us believe that the inflationary mechanisms described earlier will largely wither away if a policy of fear accompanies the eventual expansionary policy. It is our view that in fact inflation will start to accelerate once unemployment has been substantially reduced, not just in spite of recent restrictive policies but because of them.

Canadian labour feels that it has been singled out as the prime target of restrictive policies. As a result, the lessons that labour will have learned over the past decade are that it has been treated unfairly and that, when its market power rises as the unemployment rate falls, it has a chance to recoup its past losses.

The conflict-ridden nature of labour-management relations in Canada will be a determining factor here. So will the decentralized nature of decision making in collective bargaining. Wage-wage inflation especially will intensify. Each bargaining unit in its effort to make up for the past will want to be sure that it does not fall behind other units who (it is believed) have not been overcome with fear.

The fact of the matter is that there is no way under current institutional arrangements to alter the cost-push mechanisms that come into play when labour markets tighten. As long as unions exist, they will rise up again when policy has been reversed. Labour will always be concerned with fair treatment and rightly so, and will impose fairness considerations in wage settlements when unemployment rates are low enough.

Given the long history of adversarial labour relations in Canada and the fragmentation of the labour movement and of employers' associations, we do not believe that an incomes policy based on fear will work. It should go without saying that such a policy is highly questionable on moral grounds. Rather the force of the inflationary bias will be strengthened by current policies. Nor do we consider that statutory wage and price controls are a possible means of controlling inflation at full employment in any long-run sense.

The only way to achieve price stability at full employment is through an incomes policy of a very different sort. We advocate a policy that is permanent, because the inflationary bias is a permanent feature of the Canadian economy, and voluntary because we believe that is the only viable kind of policy in a democracy. The policy we advocate is based upon cooperation, not fear.

Before any policy aimed at recovery will work it must be credible. The authorities need to demonstrate convincingly that a permanent incomes policy based on cooperation is the only means to containing inflation while allowing full employment and that if this kind of incomes policy will not work they will revert to a policy of high unemployment and stagnation in order to contain inflation. We believe the implementation of this type of policy is the only means to growth without inflation in a world in which cost-push forces generate inflation.

Like any incomes policy it aims to induce wage and price behaviour consistent with national goals; in this case, however, not through fear but through a desire to cooperate. Only a genuine wish to cooperate will restrain the market participants from utilizing their potential power at full employment to initiate and sustain cost-push inflation. By aiming for cooperation, this incomes policy gets at the root cause of inflation, that is, the struggle by workers and employers to impose their particular interpretation of a "fair" wage and a "fair" price in labour and product markets. Also unlike current restrictive policies, it attacks inflation without increasing antagonisms and divisions through higher unemployment.

The question, however, is not only how to achieve credibility of the incomes policy but how to bring about its acceptability; for only if policy is acceptable as well as believable is it likely to have much chance of success.

There should be no difficulty in convincing people that if a cooperative incomes policy fails and inflation continues, the authorities will implement restrictive policies. Government in Canada will no longer consider full employment as a goal of the highest priority if it has not found a way in which to contain inflation at full employment.

Convincing groups that a cooperative incomes policy is able to contain inflation is a much more difficult task. Quite naturally much will depend upon the nature of such a policy, which we will discuss shortly, but some general remarks are appropriate.

The economist can help by exposing the myth that restrictive policies are the only way to fight inflation. Clearly those policies can reduce inflation, but adherence to them will doom Canadians to long-term high unemployment, low capacity utilization of our capital, and low productivity growth.

Economists should help to convince our leaders that inflation is a cost-push phenomenon and that any program that succeeds in containing inflation will do so to the extent that it neutralizes the cost-push mechanism. Also, work needs to be done in structuring the cooperative incomes policy. What is involved here is formulating wage and/or price guidelines and measures to induce compliance with the guidelines.

Two critical factors need to be taken into account in doing this: the nature of the industrial relations system, in particular whether it is adversarial or cooperative; and second, the degree to which the trade union movement is centralized.

The importance of these two factors has been well demonstrated by the experience of several continental European economies. In these countries credible, acceptable and, most important, workable incomes policies based on cooperation between labour and employers have been in effect at various times in the postwar period. Relative price stability has been achieved while unemployment has been reduced to a bare minimum and this has been accomplished in countries with union movements far more powerful than that in Canada.

What these economies have in common is generally harmonious industrial relations, extensive welfare systems and governments committed to full employment. In this setting labour and employers pursue their mutual long term interest by agreeing to wage settlements that are consistent with national macroeconomic goals such as a target inflation rate.

The "Continental model" relies upon coordination of collective bargaining across broad segments of the economy, thus avoiding wage-wage inflation, while government input provides information about policy goals and economic conditions, and suggests guidelines that avoid wage-price inflation. In these social consensus economies collective bargaining is free of direct controls. Wage restraint, recognized as being in the general interest, is voluntary. Social consensus incomes policies have prevailed in these economies for many years; their credibility and acceptability are based upon trust and cooperation between labour, employers and government.

The framework for social consensus policies, however, is a harmonious industrial relations and centralized collective bargaining system. This is in direct contrast to Canada's adversarial labour-management relations and fragmented labour movement. For the foreseeable future, social consensus incomes policies are not a possibility. Social consensus policy as an alternative anti-inflation policy is included here because it has been successful in several countries, and to demonstrate that it has the characteristics required for success: credibility, acceptability and permanent, voluntary wage restraint.

To be acceptable as well as credible, however, an anti-inflation policy for Canada must take account of our fragmented, adversarial industrial relations system. It is for just such a system that tax-based incomes policies (TIP) have been proposed. Here we shall advocate a TIP as the cornerstone of the only viable alternative to the current fear-based incomes policy.

Because the incomes policy must be permanent, it must also be voluntary. TIPs are voluntary by design, simultaneously avoiding direct controls and interference in free collective bargaining. They intervene in the wage-price spiral by providing incentives to induce voluntary compliance with an announced wage norm.

These incentives may be any combination of tax rewards for compliance and penalties for non-compliance, applied to employers or employees. Collective agreements are freely negotiated as always, but while wage increases in excess of the norm are allowed, they are made less attractive by the system of rewards and penalties.

A wage norm is chosen in preference to a price norm for two reasons. First, Canadian wages are determined in Canada, but in Canada's open economy many prices, of imported goods and raw materials, are outside the jurisdiction of Canadian governments and cannot be controlled. Second, many prices of goods produced in Canada are determined as a mark-up over costs, so that reducing the rate of labour cost increases will reduce the rate of increase of these prices. If there is no wage norm, there is a third argument against a price norm; it could result in a profits squeeze serious enough to have a negative effect on investment, and hence on productivity.

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This is equivalent to saying that even if a price norm could be used to control inflation, it would still require voluntary wage restraint if economic growth is not to suffer. On economic grounds a wage norm is necessary; a price norm is not.

TIPs have been criticized on various grounds. Many criticisms centre on the allegation that they are anti-labour in concept and application. This need not be so.

It is, in fact, difficult to envision a policy more anti-labour than that currently operating (excluding a "Chilean solution"). Policy-induced unemployment is a direct attack on those who lose their jobs, and the fear of unemployment is a less than subtle attack on the stronger, unionized segments of the labour force. Unions have already been weakened, and the "imminent recovery" that will rescue them is a phantom. Rather, a continuation of current restrictive policies will only lead to a continued weakening of the union movement.

In addition, government spending freezes or cutbacks are eroding social services, including health, education, consumer protection, and unemployment insurance. One can cite the retrenchment policies in British Columbia. Only by returning to full employment will we be able to generate the growth needed to preserve these social services.

Labour quite justifiably feels that it is being discriminated against today, and fears similar discrimination will result from a TIP, particularly if a wage norm is adopted.

What must be made clear is that the adoption of a wage norm is not because labour is somehow to "blame" for inflation. It should be emphasized that the wage-price spiral results from the rational behaviour of individual unions pressing wage claims and the ability of individual firms to pass wage cost increases through to prices during periods of low unemployment and strong demand. The problem or blame rests with the adversarial nature and fragmentation of the industrial relations system, with its lack of coordination and lack of incentive to consider the broader context.

The belief that a TIP is basic to the only policy alternative to continued stagnation and unemployment is necessary, but far from sufficient, to guarantee that a TIP will be formulated that is at once acceptable to the parties concerned and workable. The acceptability and the effectiveness of the policy will depend upon its details. In particular, the wage norm must be low enough to control inflation as well as being adhered to by most labour groups.

Clearly, the cooperation of labour is essential, since so much is being asked of it. The framework for this cooperation can be reduced to three points which must be understood clearly:

- If a workable TIP cannot be established, the government will abandon full employment goals and revert to its restrictive policies.
- The principles of fairness in wage determination will be incorporated in the formulation and application of the TIP.
- TIPs are limited, like all anti-inflation policies, in being unable to protect real wages (or profits) against external shocks.

The first of these points has already been discussed as necessary for ensuring the credibility of policy. However, by a slight rewording an important condition for the acceptability of a TIP emerges. Acceptance of TIP together with policies that will move us back to full employment obviously mean that we will not have to revert to restrictive policies that involve high unemployment, low investment, slow or even negative productivity growth and cutbacks in social benefits.

TIPs reject unemployment as unacceptable, and induce the cooperative effort required to control inflation. Restrictive policies, in contrast, deliberately prevent full employment in order to induce the fear required for their success.

It must be continuously stressed that by accepting a wage norm labour will receive in exchange full employment, a resumption in the growth of real incomes and the preservation of the many welfare measures we all enjoy. For employers, incidentally, the inducements include higher profits, growing markets and a reduction of macro risks.

The second point is vitally important to the longer term maintenance of the TIP. It entails the recognition of labour as a full partner, with employers and government, in discussions to determine the most widely acceptable form of the policy. This will need some changes in attitude. Anti-union sentiment, union militancy and inter-union rivalry must be suspended, or at least softened.

Given the government's target inflation rate, discussion of the wage norm will, for example, be concerned with equity in the distribution of wage and non-wage incomes, a point of some importance in the absence of an effective price norm. In the interest of relative wage fairness, the wage norm must apply to the salaries and bonuses of management and to the various stipends and allowances paid to our elected representatives.

At the same time, equity may demand some exemptions from penalties, for example in the case of the lowest paid workers. These, however, should be rare. For the majority, relative wage fairness will be fostered by the TIP incentives, which act to reduce the frequency of wage settlements above the norm, or use tax penalties to render such settlements less inequitable after taxes.

It is important that the provisions of the TIP be fair, and clearly seen to be so. To this end the broadest possible representation must be encouraged in these discussions. Political leadership is important here, since some means must be found to represent non-unionized labour and the unemployed. The coverage of employer associations may also need to be extended. Only with broad representation can a widely accepted program be established, and labour convinced of the equity of its application.

The third point deals with the concern of labour to protect real wages from erosion by inflation. The plain truth is that real wages cannot, in the aggregate, be insured against adverse movements in the exchange rate or the terms of trade, *whether or not there is an incomes policy.* In the short term measures could be taken to soften the impact.

For example, subsidies or reductions in excises could be used to "phase in" the higher import prices. A second possibility exists if there is cheaper domestic supply, although insufficient to meet total Canadian demand. A "Canadian price" calculated as a weighted average of the domestic and foreign prices of the good could be used to distribute more equitably the real wage loss, along the lines already used for petroleum pricing. Neither of these measures will reduce the real wage loss, only redistribute it over time or over the population.

In the longer term, real wage losses can be offset only through productivity increases, or by favourable movements in the terms of trade or exchange rates. Policies introduced to soften the impact of some shocks may have value in making a TIP more acceptable. But the success of the TIP must be judged separately from the effectiveness of these measures.

More generally, there are limitations to the ability of the economy to satisfy expectations. It is the task of governments and their economic advisors to provide information—about economic performance, about policy objectives and about the way these objectives are to be realized—so that expectations are realistic. But it can also be kept in mind that TIPs, in allowing high levels of employment and economic growth, have the potential to make today's unrealistic expectations realizable in the future. Restrictive demand policies hold no such promise.

The anti-inflation policies discussed here, and indeed all anti-inflation policies used in Canada in the recent past, have relied upon direct or indirect interference with the wage-price spiral. This includes the statutory controls of 1975-78 and the current "6 and 5" program. Among these policies, only restrictive demand acts indirectly on the wage-price mechanism, and it does so by creating high unemployment. Of the rest, social consensus is not feasible in Canada, and statutory controls are ruled out as divisive and impossible to maintain permanently. The "6 and 5" solution is selective, and as such is overtly unfair, and similarly impossible to maintain permanently.

The point here is that a policy centered on TIP is not only *an* alternative to current policy, but that it is the *only* alternative.

Criticisms of TIPs as "anti-labour" can be answered, and part of the answer involves the recognition of labour as an equal partner with government and capital in seeking the components of a TIP that will determine its success. Labour will have a strong voice and can pursue its goals of fair treatment.

Current restrictive policy makes no demands of labour. Each group is free to act in its own best interest. Currently, labour's best interest lies in making concessions, accepting employers' terms and hoping not to become unemployed.

The major advantage of a TIP is straightforward: it will permit low unemployment and economic growth. Its major difficulty is the requirement of cooperation from all sectors of the economy, in a setting of adversarial industrial relations.

Quite obviously, a TIP is not an easy solution to our economic problems. But the alternative is to learn to live with these problems permanently, or exchange them for the problem of ever-accelerating inflation. We believe that much of the force behind the argument that a cooperative incomes policy based on a TIP "will not work" stems from some unsupportable and vague notions that stagnation cannot go on forever. Unfortunately those who see the light at the end of the tunnel have been doing so for almost a decade.

It is also our conviction that if Canadians could be convinced, as we are, that a permanent condition of stagnation and high unemployment is the best that can be expected from current policies, enough interest and concern could be generated in designing an incomes policy that would work.